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No. 86-1119

In the Supreme Court of the United States

OCTOBER TERM, 1986

RICHARD DRAYTON, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether the receipt in 1981 of the interest component of Certificates of Value, which were delivered to the Delaware and Bound Brook Railroad Company (D&BB) as compensation for the D&BB's transfer of its rail properties to the Consolidated Rail Corporation (Conrail) in 1976, constituted ordinary income taxable under Section 61(a) of the Internal Revenue Code.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A29) is reported at 801 F.2d 117. The opinion of the district court (Pet. App. A30-A40) is reported at 632 F. Supp. 95.

JURISDICTION

The judgment of the court of appeals was entered on September 11, 1986. A timely petition for rehearing was denied on October 7, 1986 (Pet. App. A43-A44). The petition for a writ of certiorari was filed on January 5, 1987. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioners are escrow agents of the Delaware and Bound Brook Railway Company ("D&BB"). In 1879, the D&BB leased all of its rail properties to the Reading Company for a period of 990 years. By 1973, the Reading Company, along with other major Northeast and Midwest railroads, was in bankruptcy reorganization proceedings. Congress addressed the railroad crisis and superseded the normal reorganization process by passing the Regional Rail Reorganization Act of 1973 (Rail Act), 45 U.S.C. 701, in a comprehensive effort to save the Nation's railway system. The D&BB was affected by the Rail Act because of its long-term lease with the bankrupt Reading Company. Pet. App. A3, A9.

The Rail Act established a non-profit government corporation (the United States Railway Association, or USRA), a for-profit private corporation (the Consolidated Rail Corporation, or Conrail), and a special three-judge court (the Special Court). Under the Rail Act, USRA was charged with developing and implementing a Final System Plan for restructuring the railroads into a financially self-sustaining rail system. The Final System Plan was to provide for the transfer of certain of the properties of the bankrupt railroads to Conrail. In exchange, the railroads whose properties were transferred were to receive common and preferred Conrail stock, plus up to $500 million of USRA obligations guaranteed by the United States. Pet. App. A3.

The bankrupt railroads' major creditors challenged the constitutionality of the Rail Act, principally on the ground that the transfer of the rail properties was an unconstitutional taking without just compen-

sation. In the *Regional Rail Reorganization Act Cases* (*Rail Act Cases*), 419 U.S. 102 (1974), this Court upheld the constitutionality of the Rail Act. With respect to the taking claim, the Court explained that the existence of a remedy under the Tucker Act, 28 U.S.C. 1491, precluded a finding that there was no just compensation. 419 U.S. at 148-149.

Thereafter, Congress took action to forestall a possible flood of Tucker Act suits by amending the Rail Act. The Railroad Revitalization and Regulatory Reform Act of 1976 (4R Act), Pub. L. No. 94-210, 90 Stat. 31, changed the manner of compensating the transferor railroads. Instead of simply depositing Conrail stock with the Special Court, the 4R Act required Conrail to deposit both Conrail stock and Certificates of Value (CVs) issued by USRA. See Pet. App. A5. It is these CVs that are the focus of this litigation.

The CVs were guaranteed by USRA and were subject to redemption by USRA on December 31, 1987, or at such earlier time as USRA might determine (Pet. App. A6). Each CV had a "base value" that was to be determined as follows (45 U.S.C. 746 (c)(4) (emphasis added)):

> (A) taking the net liquidation value, as determined by the special court * * *;
>
> (B) subtracting the value of other benefits provided under this [Act] as determined by the special court;
>
> (C) adding such amount, if any, as the special court may determine shall be required after taking into consideration compensable unconstitutional erosion, if any * * *;
>
> (D) *adding interest from the transfer date to the redemption date to be compounded annually at a rate of 8 percent per annum*; and

(E) dividing the resulting value by the number of certificates of value of such series distributed to such transferor.

In short, the redemption price for the CVs was to be the difference between the liquidation value of the transferor's assets and the value of any other compensation given to the transferor, plus an interest adjustment. The CVs were intended to make up for any shortfall in the compensation provided by the original Rail Act that would result from the low value of the Conrail stock and USRA bonds. The CVs thus were designed to ensure that all transferors received their constitutional due without the need for bringing a Tucker Act suit against the United States. See Pet. App. A8.[1]

Thereafter, Conrail continued to be dependent upon federal assistance, and its stock remained virtually worthless. On August 13, 1981, in response to this poor performance, the Rail Act was amended again. This amendment provided that all Conrail stock should be transferred to the Secretary of Transportation and that such stock should be deemed to have zero value for purposes of computing the amount for which CVs were redeemable under the Rail Act. Omnibus Budget Reconciliation Act of 1981, Pub. L. No. 97-35, § 1167, 95 Stat. 686 (codified at 45 U.S.C. 1115). As a result of this legislation, ownership of

[1] At the same time that Congress passed the 4R Act it also enacted the Act of March 31, 1976, Pub. L. No. 94-253, § 1(a), 90 Stat. 295, which added Section 374(c) to the Internal Revenue Code (26 U.S.C.). Section 374(c) states that no gain or loss shall be recognized by a transferor railroad corporation upon its receipt of Conrail stock and CVs in exchange for its transfer of rail properties to Conrail pursuant to the Final System Plan.

Conrail was vested exclusively in the federal government, and CVs became the sole source of payment from Conrail to the transferor railroads. See Pet. App. A9.

2. Pursuant to the Final System Plan, the D&BB's rail property was transferred to Conrail on April 1, 1976. Thereafter, USRA estimated the net liquidation value of the D&BB's rail property to be about $1,150,000. The D&BB did not accept that figure, however, and it filed a complaint with the Special Court. In August 1981, shortly after the Omnibus Budget Reconciliation Act of 1981 was passed, the D&BB and USRA entered into a settlement agreement regarding the litigation in the Special Court. In accordance with that agreement, the D&BB received CVs having a total worth ("Base Value") of $6,802,660. This "Base Value" figure consisted of two components—the "Principal Amount of CVs" ($4,408,417) and "CV Interest" ($2,394,243).[2] The "Principal Amount" component represented the "net liquidation value" of the D&BB's rail properties on April 1, 1976, the date on which those properties were transferred to Conrail. The "CV Interest" com-

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[2] The D&BB and USRA agreed that "the value of other benefits" (VOB) conferred by the Act was zero and that there had been no "compensable unconstitutional erosion" (CUE). See 45 U.S.C. 746(c)(4)(B) and (C). Pursuant to the formula set forth in 45 U.S.C. 746(c)(4), therefore, the settlement agreement computed the "Base Value" of the CVs as follows (C.A. App. 49):

Net Liq. Value	VOB	CUE	Principal Amount of CVs	CV Interest (As of 11/15/81)	Base Value of CVs (As of 11/15/81)
$4,408,417	-0-	-0-	$4,408,417	$2,394,243	$6,802,660

ponent represented 8% annual interest on the "Principal Amount" component, accruing from the transfer date of the rail properties until the redemption date of the CVs. See 45 U.S.C. 746(c)(4)(A) and (D); Pet. App. A10-A11.

In November 1981, USRA redeemed the CVs held by the D&BB for the full $6,802,660. After sharing part of this money with the Reading Company, its lessee, the D&BB liquidated its assets and distributed the proceeds to its shareholders pursuant to Section 337 of the Internal Revenue Code.[3] The D&BB subsequently sought two separate private letter rulings from the IRS concerning the interest component of the CVs. The D&BB claimed that this component was partial payment for the transferred rail property, thus constituting a return on capital that should be taxed as a capital gain. The IRS disagreed, however, and ruled that the interest component represented ordinary interest income taxable to the D&BB under Section 61(a)(4) of the Code. The IRS also disagreed with the D&BB's suggestion that the interest component should be eligible for nonrecognition treatment under Section 337 of the Code. Pet. App. A11-A12.

In accordance with these letter rulings, the D&BB reported the interest component of the CVs as ordinary income and paid the tax thereon. Subsequently, it filed an amended return seeking a refund of the taxes paid. Following the disallowance of that claim by the IRS, petitioners, as escrow agents of the D&BB, brought this refund suit on its behalf in the

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[3] Unless otherwise noted, all statutory references are to the Internal Revenue Code (26 U.S.C.), as amended (the Code or I.R.C.).

United States District Court for the District of New Jersey. Pet. App. A12.

The district court granted summary judgment in favor of the D&BB (Pet. App. A30-A40). The court reasoned that the interest component of the CVs was "an integral part of the redemption, or base, value for rail properties," and was "not an amount in excess of the value of such properties" (*id.* at A39). Accordingly, it concluded that "[u]nder the express provisions of [I.R.C.] § 374(c), the aggregate sum received should result in no tax consequences to D&BB" (*ibid.*).

The court of appeals unanimously reversed (Pet. App. A1-A29). Relying in part on this Court's decision in *Kieselbach* v. *Commissioner*, 317 U.S. 399 (1943), the court of appeals held that the interest component of the CVs represented payment for the detention of money between the 1976 transfer date and the 1981 redemption date, and therefore fell squarely within the standard definition of interest. It accordingly concluded that the payment must be treated as ordinary interest income under Section 61(a)(4) of the Code. Pet. App. A14-A17.

ARGUMENT

The court of appeals correctly held that the interest component of the CVs is taxable as "interest" income under Section 61 of the Code. The court's decision does not conflict with any decision of this Court or of another court of appeals. The issue presented has little future significance because it concerns the proper characterization of a payment made under a unique, one-time program that is not likely to be repeated. Indeed, petitioner does not cite a single case, apart from this one, that has ever ad-

dressed the tax treatment of the interest component of the CVs. There is accordingly no need for further review.

1. Section 61(a)(4) of the Code provides that "gross income means all income from whatever source derived, including * * * interest." Congress has not used the term "interest" in the Internal Revenue Code with reference to "some esoteric concept derived from subtle and theoretic analysis." *Old Colony R.R.* v. *Commissioner*, 284 U.S. 552, 561 (1932). Rather, the term "interest" has a definite and long accepted meaning as the "compensation allowed by law or fixed by the parties for use, or forbearance, or detention of money" (*Fall River Electric Light Co.* v. *Commissioner*, 23 B.T.A. 168, 171 (1931) (citations omitted)). See, *e.g.*, *Deputy* v. *DuPont*, 308 U.S. 488, 498 (1940); *In re Timbers of Inwood Forest*, 793 F.2d 1380, 1382 n.1 (5th Cir. 1986); *Coldwater Seafood Corp.* v. *Commissioner*, 69 T.C. 966, 972 (1978); see also Treas. Reg. § 1.61-7. And the categories of income contained in Section 61 generally have been given a broad reading, with exemptions therefrom recognized only when specifically authorized by Congress. See *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 429-430 (1955).

On the other hand, this Court has long held that a narrow construction is to be accorded "capital asset," the term that petitioner asserts should encompass the interest component of the CVs at issue here. This rule accords with Congress's intent to afford capital gains treatment only where the taxpayer has realized an appreciation in value that has accrued over a substantial period of time. See *Commissioner* v. *Gillette Motor Transport, Inc.*, 364 U.S. 130, 134 (1960). Accordingly, this Court has consistently construed the term "capital asset" to exclude prop-

erty that represents either an item of income or an accretion to the value of an asset that is properly attributable to income. See *Commissioner* v. *Gillette Motor Transport, supra* (compensation awarded for rental value of facilities during period of government control taxed as substitute for rental income); *United States* v. *Midland-Ross Corp.*, 381 U.S. 54 (1965) (gain attributable to original issue discount taxed as disguised interest income); *Hort* v. *Commissioner*, 313 U.S. 28 (1941) (amounts received for cancellation of lease taxed as substitute for rental income).

In *Kieselbach* v. *Commissioner*, 317 U.S. 399 (1943), the Court addressed a situation closely analogous to that presented here. The City of New York had instituted a condemnation proceeding in which payment was made several years after the actual taking. The payment consisted of two components, one representing the value of property at the time of the taking and the other representing interest. *Id.* at 400. The Court held that the interest component was fully taxable as ordinary income under the predecessor of Section 61(a)(4). The taxpayer had urged that the interest component was taxable as capital gain because the relevant state law provided that interest was part of the total condemnation award to which the property-owner was entitled. In rejecting that argument, this Court stated that the interest payment was "indemnification for delay, not a part of the sale price" of a capital asset. 317 U.S. at 404.

Similarly here, the interest component of the CVs in question was paid under a statutory formula that expressly provided for "interest from the transfer date to the redemption date * * * compounded an-

nually at a rate of 8 percent per annum." 45 U.S.C. 746(c)(4)(D). In contrast to true capital appreciation, the interest component here was predictable and measurable in advance, and it represented compensation for the detention or forbearance of money. If full payment for the rail properties had been made on the transfer date, this interest component would obviously have been zero. Thus, the payment represented "income * * * paid to the [D&BB] in lieu of what [it] might have earned on the sum found to be the value of the property on the day the property was taken." *Kieselbach* v. *Commissioner*, 317 U.S. at 403. In these circumstances, the court of appeals was clearly correct in holding that the interest component received by the D&BB on the CVs constituted ordinary interest income taxable under Section 61(a)(4) of the Code.

2. Petitioners contend (Pet. 13-20) that the decision below is inconsistent with this Court's decision in the *Regional Rail Reorganization Act Cases*, 419 U.S. 102 (1974). This contention is without merit. In the *Rail Act Cases*, the Court upheld the constitutionality of the Rail Act on the ground that the availability of a Tucker Act remedy ensured that the transferors would receive just compensation for their properties even if it turned out that the Conrail stock and USRA bonds that they received in exchange were not themselves adequate. The Court held that "[a]s long as creditors are assured fair value, with interest, for their properties, the Constitution requires nothing more" (*id.* at 156). Petitioners here have received "fair value, with interest, for their properties" (*ibid.*), and this case accordingly presents no constitutional claim. Rather, the sole question here concerns the proper treatment, for federal

income tax purposes, of the interest that petitioners received. Since the Court in the *Rail Act Cases* did not address any income tax questions, and since the particular instruments at issue here—CVs with both "principal" and "interest" components—were not even created by Congress until several years after this Court decided the *Rail Act Cases*, it is difficult to see how that decision could reasonably be said to conflict with the decision below.

The gist of petitioners' contention in this regard appears to be that the Court in the *Rail Act Cases* viewed the Rail Act as effecting an "*exchange* in furtherance of a plan of reorganization" (Pet. 13 (emphasis in original)), rather than a public condemnation that required full and immediate cash payment for the rail properties (see 419 U.S. at 149-150). From this premise, petitioners deduce that the CVs, including the interest component, are indivisible assets received in an exchange of property. The interest component, petitioners argue, should be viewed merely as "growth" in the value of those assets and therefore eligible for capital gain treatment. See Pet. 13-14.

This contention misses the mark for several reasons. To begin with, petitioners' contention ignores the fact that the compensation mechanism involved here is not the same as the one before the Court in the *Rail Act Cases*. Three years after the *Rail Act Cases* were decided, the 4R Act created the government-guaranteed CVs at issue here, requiring USRA to deposit them with the Special Court to fill any gap in compensation caused by the low value of the Conrail stock and USRA bonds (see Pet. App. A5-A8; 45 U.S.C. 746(a)). In 1981, the statute was amended again; the Conrail stock was deemed to

have zero value and 100% of that stock was transferred to the government, with the result that the CVs became the sole source of payment from Conrail to the transferor railroads. 45 U.S.C. 1115. Thus, after 1981, the concept that part of the compensation for the transfer of the rail properties would take the form of equity in a private corporation was no longer operative. In the end, petitioners received no equity; and the fact that there was no "growth" in the value of their railroad assets was clearly demonstrated by the decline in the value of the Conrail stock to zero by 1981. As the court of appeals observed (Pet. App. A22-A23), therefore, it is highly questionable whether this Court's statement in the *Rail Act Cases* characterizing the 1973 version of the Rail Act as a bankruptcy reorganization statute should be viewed as fully applicable to the revised statutory scheme at issue in the present case.

In any event, even if the Rail Act were properly characterized as a reorganization statute, the interest component of the CVs would still be subject to taxation as ordinary income. Pursuant to Section 374 of the Internal Revenue Code, the D&BB's 1976 exchange of its rail properties for CVs and Conrail stock was treated as a tax-free exchange, with no gain or loss being recognized to the D&BB at that time. At that time, of course, the value of the "interest component" of the CVs was zero. But the transaction at issue here does not concern the original 1976 exchange of assets for CVs; rather, it concerns USRA's redemption of those CVs five years later, by which time the "interest component" of the CVs had risen to $2,394,243. As the court of appeals correctly pointed out (Pet. App. A14-A15), the redemption is a wholly different transaction from the initial exchange of rail property for securities. The

government is not now seeking to impose, any more than it sought in 1976 to impose, any tax on the "principal component" of the CVs, which corresponds to the 1976 net liquidation value of the rail property. What the government seeks to tax is the interest that accrued on that principal during the subsequent five-year period. Obviously, the fact that a taxpayer has received a debt instrument in a tax-free reorganization in 1976 does not mean that the interest on that debt—either under Section 374 or under general tax principles—is perpetually immune from tax. It was the 1981 redemption of the CVs, not their receipt in the 1976 exchange, that caused them to have an interest component that is taxable to the D&BB under Section 61(a)(4). Accordingly, the decision below is fully consistent with this Court's characterization of the Rail Act as a "reorganization statute" in the *Rail Act Cases*.

By the same token, there is no merit to petitioners' contention (Pet. 16) that the reorganization aspects of the Rail Act render *Kieselbach* v. *Commissioner*, *supra*, irrelevant. There is no reason why the decision in *Kieselbach* should be limited to condemnation statutes. The two factors upon which the finding of taxability in *Kieselbach* hinged are both present here. First, the D&BB was not paid for its rail property until substantially after the transfer date. Second, as compensation for the five-year delay in payment, the D&BB received an amount over and above the 1976 value of that property—an amount computed at 8% per annum. In this case, as in *Kieselbach*, the property owner was under legal compulsion to transfer the property at a specified time and could not withhold transfer until payment was received. To compensate the owner for that delay, the ultimate cash payment included an interest component. Hence,

condemnation proceeding or not, the rationale of *Kieselbach* is fully applicable here.

Finally, we note that petitioners' theory that the interest component of the CVs represented "growth" in the value of an equity investment (Pet. 15) necessarily incorporates several illogical assumptions. First, there is no reason to suppose that Congress would have wanted to pay the transferor railroads for capital "growth" after the transfer of their railroad property. Second, petitioners' theory irrationally presupposes that the D&BB and the other transferors gave Conrail free use of their money for an indefinite period subsequent to the conveyance date. Third, as noted above, the D&BB never received any equity investment and, even if it had received one, the "growth" in value would have been negative, since the value of the Conrail stock, at the time it was transferred to the government in 1981, was zero. The interest component of the CVs must therefore be characterized as "interest" income under Section 61(a)(4) of the Code, just as Congress denominated it. See *Starker* v. *United States*, 602 F.2d 1341, 1356 (9th Cir. 1979) (six-percent "growth" factor in land exchange agreement held to constitute disguised interest income, not capital gain).[4]

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[4] Petitioners also contend (Pet. 16-24) that the court of appeals erred in failing to recognize that the D&BB had a legal and equitable right to receive compensation in the form of Conrail stock, as contemplated in the original Rail Act. It is not apparent how this contention supports petitioners' ultimate view that the interest component of the CVs should not be taxed. Even if petitioners had some legitimate expectation of compensation in the form of equity, which the court of appeals correctly held they did not (see Pet. App. A26-A28), that would not affect the taxability of the CVs that they actually received. It is well established that a transaction is

3. Contrary to petitioners' assertion (Pet. 26-28), the decision below does not conflict with the decision in *Commissioner* v. *Carman*, 189 F.2d 363 (2d Cir. 1951). In *Carman*, the taxpayer bought certain railroad bonds, the interest on which had been in default since 1933. In 1935, the railroad filed a petition for reorganization under the Bankruptcy Act, and in 1939 a plan was approved by the district court. Consummation of the plan was delayed for five more years by litigation, however, and it was not until December 29, 1944, that the plan went into effect. On that date, the taxpayer surrendered his bonds and received in exchange new bonds, preferred stock, common stock, and cash. The cash represented "adjustment payments" to compensate the taxpayer for the five-year delay between the development of the plan and its consummation. See 189 F.2d at 364. Although the Tax Court held that the "adjustment payments" were taxable to the taxpayer as ordinary income, the court of appeals reversed, holding that such payments were received as part of the reorganization plan and were taxable as "boot," not as ordinary income.

As the court of appeals correctly noted (Pet. App. A24 n.9), the decision in *Carman* is not in conflict with the decision below because it turned on factors not present here. The taxpayer in *Carman* had full control over his bonds between 1939 and 1944; he could have transferred them or sold them at will. He did not exchange his bonds until 1944, at which time he was paid in full when he received new bonds,

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to be given its tax effect "in accord with what actually occurred and not in accord with what might have occurred." *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 148 (1974).

stock, and cash. Because there was no post-exchange delay in the taxpayer's receipt of this consideration, the entire consideration received was logically viewed as being received in exchange for the property surrendered. There was thus no occasion in *Carman* to find any "interest component" in the transaction. Here, by contrast, the D&BB gave up all rights to its property in April 1976, and it did not receive any cash in exchange for that property until 1981. The "interest component" attributable to that delay in receiving payment was correctly treated as interest income.[5]

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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APRIL 1987

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[5] In addition, we note that *Carman* was decided prior to the enactment of the unstated interest provisions of Section 483 of the Code. The courts of appeals, including the Second Circuit, have consistently held that interest is imputed under that provision in cases involving delays with respect to the issuance of securities in reorganizations. *Kingsley* v. *Commissioner*, 662 F.2d 539 (9th Cir. 1981); *Vorbleski* v. *Commissioner*, 589 F.2d 123 (3d Cir. 1978); *Solomon* v. *Commissioner*, 570 F.2d 28 (2d Cir. 1977); *Jeffers* v. *United States*, 556 F.2d 986 (Ct. Cl. 1977). The result in *Carman*, therefore, might well be different if it were decided today.

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